Monetary Policy Statement (July-December, 2014): A Rapid Assessment

Bangladesh Economic Update

August 2014

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1. INTRODUCTION

The current issue of the Bangladesh Economic Update focuses on the recently announced half-yearly Monetary Policy Statement (MPS) for the period of July-December of FY 2014-15, by the central Bank, Bangladesh Bank (BB).

The current issue of the Bangladesh Economic Update focuses on the recently announced half-yearly Monetary Policy Statement (MPS) for the period of July-December of FY 2014-15, by the central Bank, Bangladesh Bank (BB). The Update examines the current MPS in the background of three major economic issues – debt-financing-instrument-based (bank borrowing) deficit financing leading to higher inflation, presence of huge idle money in the banking system not coming into system as investment and the implications of both in affecting the national income.

A review of the last five MPSs including the recent one announced by BB indicates that the targets set in the MPSs have been falling short, implying the lack of effectiveness and crisis of credibility in both formulating and implementing the MPSs.

A review of the last five MPSs including the recent one announced by BB indicates that the targets set in the MPSs have been falling short, implying the lack of effectiveness and crisis of credibility in both formulating and implementing the MPSs. With a view to restraining the inflationary pressure and ensuring sufficient credit growth to stimulate inclusive economic growth, the central has recently pursued a monetary policy that keeps high policy rate along with higher cash reserve ratio (CRR). This policy of high policy rate and high CRR may contract the ability of the banking system to lend to the private investors causing the continuation of declining trend in private investment on the one hand and the use of funds by the government to finance the budget deficits and non-development expenditures on the other – leading to deceleration in the growth in gross domestic product (GDP).

Government has proposed the budget of Tk. 2, 50,506 crore for the FY 2014-15 where the deficit is set at Tk. 67,552 crore without grants. In order to finance this large deficit, the government plan to borrow Tk. 31,221 crore from the banking system, which may create inflationary pressure in the economy since the government is to expend a large amount of money in financing the non-development expenditure. Besides, existence of excessive liquidity has been observed in the banks. An amount of Tk. 1, 38,200.54 crore has been found as liquidity surplus in the banking system in March 2014, whereas the amount was calculated at

The target of achieving a 7.3 percent rate of growth in GDP in FY 2014-15 might be proved unfeasible, unless the rising pressure of inflation and decreasing trend of private investment are addressed immediately with prudent and farsighted homogenisation of macroeconomic policies.

Tk. 79440.56 crore in June 2013. This existence of excessive liquidity will drive banks to lend in unproductive and risky sector which may worsen the inflationary situation. To lessen this pressure Bangladesh Bank has recently increased the CRR from 5.5% to 6.0%, but it might not work since it may cause the lender rate to rise depressing the private demand for credit. Consequently, the target of achieving a 7.3 percent rate of growth in GDP in FY 2014-15 might be proved unfeasible, unless the rising pressure of inflation and decreasing trend of private investment are addressed immediately with prudent and farsighted homogenisation of macroeconomic policies.

Private sector credit growth has been declining since December 2013. The rate of private sector credit growth was calculated at 1.58 percent in December 2013, whereas the rate declined to -0.13 percent in January 2014 and then slightly increased to 0.43 percent in February 2014. In March 2014, the rate of growth in private sector credit, however, reached 1.29 percent which is still below the rate of December 2013. In May 2014, the private sector credit growth has been calculated at 15.7 percent, while the private credit growth from domestic sources was 11.4 percent implying that private sector credit from overseas sources has been growing rapidly. Rapid increase in borrowing from foreign sources and slower trend of growth in credit from domestic sources may cause the target of 14 percent and 15.5 percent growth in private sector credit exclusively from the domestic sources by December 2014 and June 2015 respectively not to be achieved.

At the same time, non-food point to point inflation has been on a rising trend and was calculated at 5.45 percent in June 2014 from 5.16 percent in May 2014, while the point to point food inflation increased from 5.02 percent in January 2013 to 8 percent in June 2014. As a result, the overall average inflation has amounted to 7.35 percent in June 2014, which still remains above the target of reducing inflation below 7 percent level.

In addition to poor risk management, fraudulence driven by captured governance in the banking system resulting in lower profit to the stakeholders, the adoption of contractionary monetary policy characterised by higher CRR, high policy rate and higher interest rates on government savings tools along with declining growth in disbursement of credit to private sector cause the country's banking sector to get caught up in trap. Besides, the promotion of financial inclusion is hindered by captured governance in the management of banks, slack surveillance by the central bank, and meager actions against the fraudulence which lead to scams and increased defaults of loans in the sector.

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The present MPS is the continuation of the monetary policy instruments agreed under the three-year reform programme between the government and the International Monetary Fund (IMF). The government signed a Memorandum of Economic and Financial Policies (MEFP) with the IMF, embodying nothing but orthodox contractionary monetary and fiscal policy instruments.

The current MPS has been taken by the central bank when the country's economy is facing with major challenges such as deceleration in the rate of growth of GDP, deterioration of private sector credit growth along with high food inflation.

2. TARGETS AND ACHIEVEMENTS OF MPS

Monetary policy taken by Bangladesh Bank seems to be a reflection of the IMF conditions. Added to this are non-achievements of targets – a clearly visible distinction between the key targets and outcomes is observable - raising the issue of credibility and realism in the target setting. There is a gap between the target and achievement of credit growth to private sector, inflation as well as growth in GDP (Table 1).

The rate of growth in GDP fell below the government's budgetary target of 7.2 percent in the FY 2013-14. The adoption of unfounded contractionary monetary policy may, however, cause the rate of growth in GDP not to reach the target of 7.3 percent for the FY 2014-15.

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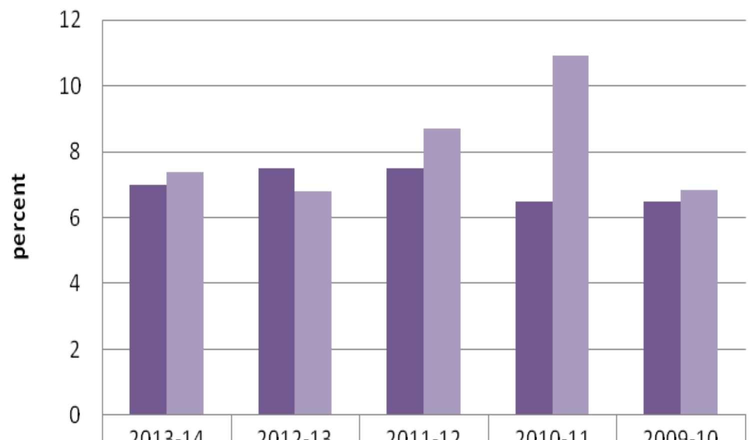
In the MPS (January – May, 2014), average inflation reached 7.47 percent against the target of below 7 percent, whereas the average food and non-food inflation for the corresponding period reached 8.93 percent and 5.31 percent respectively. The main reason of increased inflation, however, is the food price volatility.

In the MPS (January – May, 2014), average inflation reached 7.47 percent against the target of below 7 percent, whereas the average food and non-food inflation for the corresponding period reached 8.93 percent and 5.31 percent respectively.

Figure1: Target and Actual Inflation rate



	2013-14	2012-13	2011-12	2010-11	2009-10
Target	7	7.5	7.5	6.5	6.5
Actual	7.37	6.78	8.69	10.91	6.82

Source: Bangladesh Bank (various MPSs)

The rate of growth in private sector credit reached 1.29 percent in March 2014, whereas the rate was calculated at 1.58 percent in December 2013, -0.13 percent in January 2014 and 0.43 percent in February 2014. Statistics suggest that the private sector credit growth has declined to 16 percent in June 2012 from the targeted 18.5 percent in the MPS (January-June, 2012). Private sector credit growth declined to 17.4 percent from the targeted 18.3 percent in that MPS (July -December, 2012). Private sector credit growth declined to 11.43 percent in June 2013 from the targeted 18.3 percent in the MPS (January-June, 2013) due to weak physical infrastructure, inconvenient business environment as well as high interest rate lending. In the light of previous MPSs it can be assumed that the target might not be achieved if the present situation such as lack of physical infrastructure, high interest rate spread exists.

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Table 1: Targets and achievements of previous MPSs

Indicators	MPS (July-December,2014)		MPS (January-June 2014)		MPS (July - December, 2013)		MPS (January-June,2013)		MPS (July - December, 2012)	
	Target (Percent)	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Actual
Rate of Inflation	6.5	N/A	Below 7	7.35	7	7.35	7.5	8.05	7.5	7.14
Credit to Private sector	16.5		16.5	15.7 (May 14)	15.5	11.1	18.3	11.43	18.3	17.4 (Nov)
Growth Rate of GDP	7.3(Proposed budget FY2014-15	N/A	7.2 (Proposed budget FY2013-14	7.12	7.2	6.03	7.2	6.03	7.2	6.03

*Average inflation rate (January 2014 – June 2014)
Source: Unnayan Onneshan, 2014.

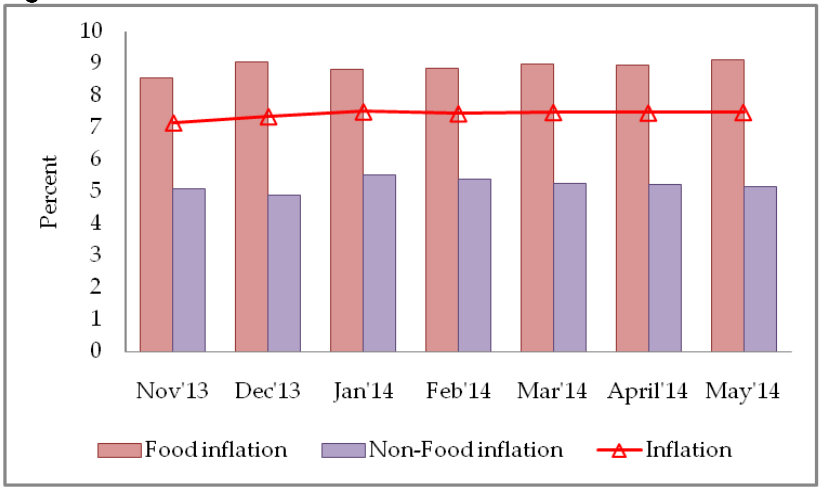
3. INVESTMENT AND MPS

Monetary policy influences investment in a number of ways. First, monetary policy is assumed to create better investment opportunity by stabilising the price level. Second, monetary policy ensures a steady flow of funds to private sector for generation of investment. Third, monetary policy instruments channel funds to productive sectors that create positive benefits to other sectors.

The increasing trend of food inflation exerts adverse impacts on poor and marginalised people.

The monetary policies declared by Bangladesh Bank in recent times, however, have been failing to bring the expected results in all the three areas. The inflation rate has been being high as well as persistent. Overall inflation increased by 0.02 percentage point in May 2014 on a point to point basis from 7.46 percent in April 2014. The food inflation increased by 0.14 percentage point in May, 2014 from 8.95 percent in April, 2014. On the other hand, non-food inflation has decreased to 5.16 percent in May 2014 from 5.23 percent in April 2014. The increasing trend of food inflation exerts adverse impacts on poor and marginalised people.

Figure 2: Trend of inflation



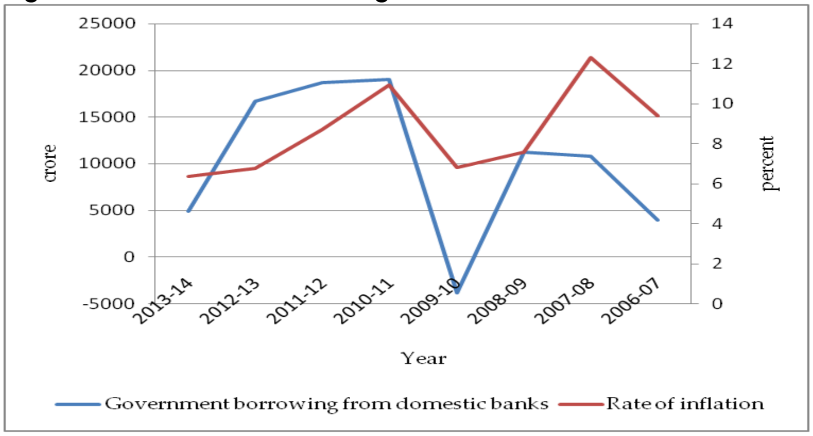
Source: Bangladesh Bank, 2014

Along with food price volatility, government borrowing and financing the unproductive expenditure also create an inflationary pressure.

Along with food price volatility, government borrowing and financing the unproductive expenditure also create an inflationary pressure. When government borrows and spends that in productive sector inflation increases initially but that loss can be made up in the long run but when it is spent on unproductive expenditure like paying salaries, interest etc. pressurises the inflation to go up and poor and people with limited income become affected. In FY2007-08, government borrowing increases to 10869.10 crore from 4002 crore in FY2006-07, inflation increses to 12.30 percent in FY2007-08 from 9.39 percent in FY 2006-07.

In FY2009-10, government borrowing from domestic banks decreased to 8626.67 crore from 17153.52 crore in FY 2008-09, inflation decreased to 6.82 percent in FY2009-10 from 7.6 percent in FY2008-09. Then in FY2010-11 government borrowing increased to 21132.55 crore, inflation increased to 10.91 percent in that fiscal year. Again in FY2011-12 government borrowing decreased to 20822.11 crore and inflation decreased to 8.69 percent. Government borrowed 24549.10 crore and 13173.10 crore in FY2012-13 and FY2013-14 (July-February) respectivly and inflation rate were 6.78 and 6.37 (July 2013-February 2014) for those fiscal year respectively. There is a strong positive trend between government borrowing and inflation (Figure3). So, that contractionary monetary policy is not adequate enough to control the inflation rate.

Figure3: Government borrowing and rate of inflation



Source: Ministry of Finance, 2014; Bangladesh Bank, 2014

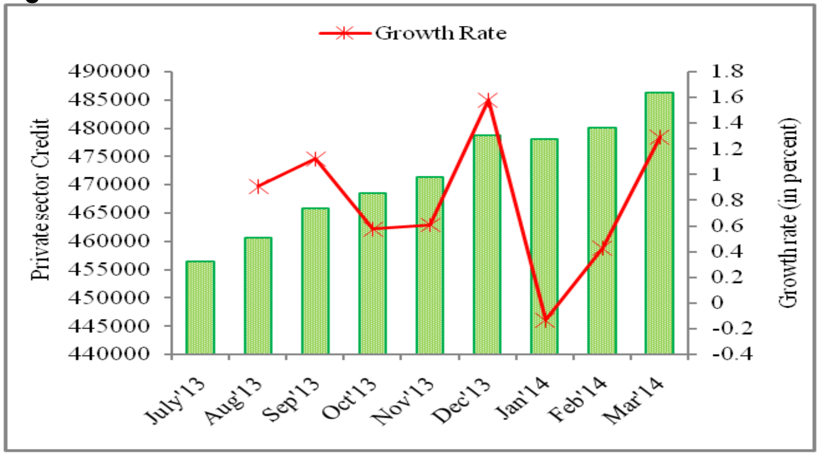
Growth of credit to the private sector slowed in recent time due to consecutive contractionary monetary policy taken by BB and lack of adequate physical infrastructure.

Growth of credit to the private sector slowed in recent time due to consecutive contractionary monetary policy taken by BB and lack of adequate physical infrastructure. Thus investment demand remains depressed and which in turn would not have been able to expand the economy. The rate of growth of actual disbursement of credit to the private sector in July to September, 2013-14 over July to September, 2012-13 are 10.18 percent, representing a 5.32 percentage point gap. If the current trend continues, the gap may further widen in September to December, 2013-14.

Despite repeatedly falling to achieve private sector credit growth, the target of credit in private sector in the current MPS has been set at 16.5 percent in December 2014.

Despite repeatedly falling to achieve private sector credit growth, the target of credit in private sector in the current MPS has been set at 16.5 percent in December 2014. This target is equal to the target (16.5 percent) of previous MPS.

Figure 4: Private sector credit



Source: Bangladesh Bank, 2014

Moreover, the government has been struggling to boost up the revenue earning. If the government falls short collecting revenue it has to resort to increasing borrowing from the bank and thus this may crowd out private investment. In the FY 2013-14, a gap of nearly Tk. 18 crore has been observed between the target and actual collection of revenue in the economy, which, as argued earlier, may cause the borrowing from banking system by the government to increase.

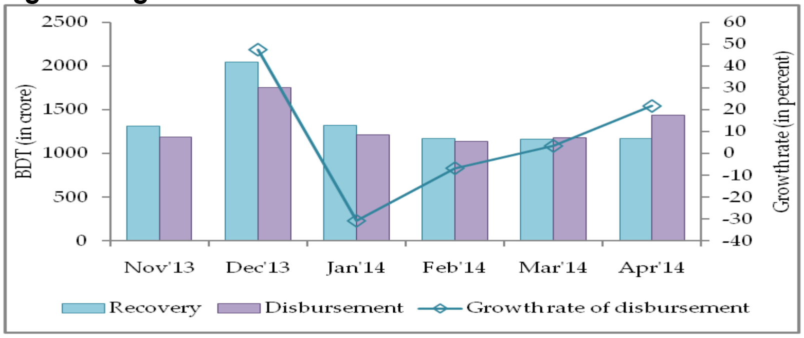
If the government falls short collecting revenue it has to resort to increasing borrowing from the bank and thus this may crowd out private investment.

Finally, lower disbursement of credit as well as lower recovery in agricultural, industrial, and SME loans not only increase the default loans but also may impact on growth prospects of the economy in the medium term, resulting in farther contraction of the economy.

3.1 Agricultural Credit

The rate of growth of agricultural credit disbursement and recovery of credit has been experiencing lower trend as well as negative rate of growth after December, 2013. The disbursement of agricultural credit stood at Tk. 1757.5 crore in December, 2013, whereas it became Tk. 1218.97 crore in January, 2014. In February, 2014, the disbursement of agricultural credit also decreased by Tk. 79.93 crore, whereas the amount slightly increased 1180.05 crore and 1438.05 crore in March and April of FY 2013-14 respectively. The rate of growth of the disbursement of the agricultural credit, therefore, stood at negative 6.56 percent, positive 3.60 percent and positive 21.86 percent in February, March and April of 2014 respectively. On the other hand, recovery of the agricultural credit disbursement has been increasing at an insignificant amount.

Figure 5: Agricultural credit



Source: Bangladesh Bank, 2014

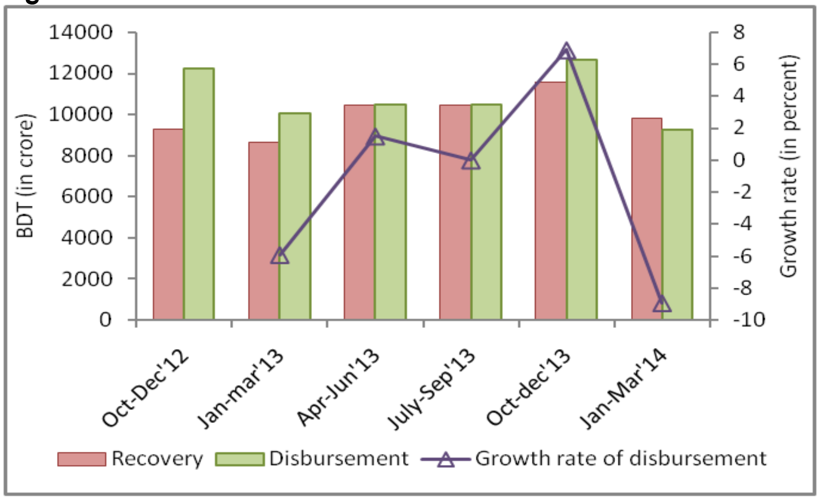
3.2 Industrial Term Loan

The rate of growth in the industrial term loan has been experiencing an irregular movement with frequent negative rate of growth. Adequate capital is needed for industrialisation of a country. Loan is one of the most important factors of capital formation, mainly for developing country like Bangladesh.

The condition of the recovery of the industrial term loan has been improving by insignificant amount since the last quarter of the FY 2012-13.

The disbursement of industrial term loan stood at Tk. 9283.5 crore in the January-March quarter of the FY 2013-14, which is the lowest among the last five quarters, whereas it was Tk. 10513.27 crore and Tk. 12684.66 crore in July-September and October-December quarters of the FY 2013-14. As a result, the rate of growth of the disbursement of the industrial term loan stood negative at 8.94 percent in the January-March quarter of the FY 2013-14, compared to the positive rate of growth of 6.88 percent in the October-December quarter of the same fiscal year. The condition of the recovery of the industrial term loan has been improving by insignificant amount since the last quarter of the FY 2012-13.

Figure 6: Industrial Term Loan

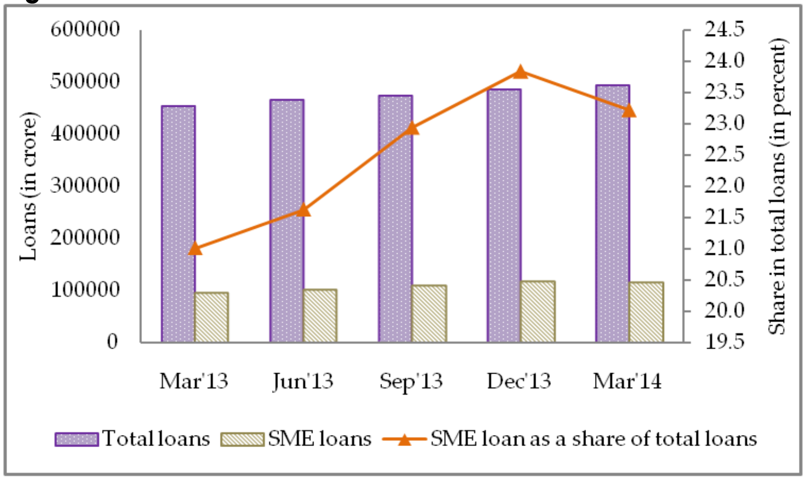


Source: Bangladesh Bank, 2014

3.3 SME Loans

Although the total loan given by state owned commercial banks, foreign banks, and non-bank financial institutions, except the specialised banks, increased to Tk. 493306 crore at the end of March 2014 from Tk. 455884.6 crore at the end of December 2013, the SME loan as a percentage of total loans has decreased during the same period. The total SME loan decreased by Tk. 1301.4 crore between the period of December 2013 and March 2014 and has been calculated at Tk. 114583.5 crore in March 2014. As a result, the rate of growth of SME loan has decreased from 6.71 percent in December 2013 to negative 1.12 percent in March 2014.

Figure 7: SME loan



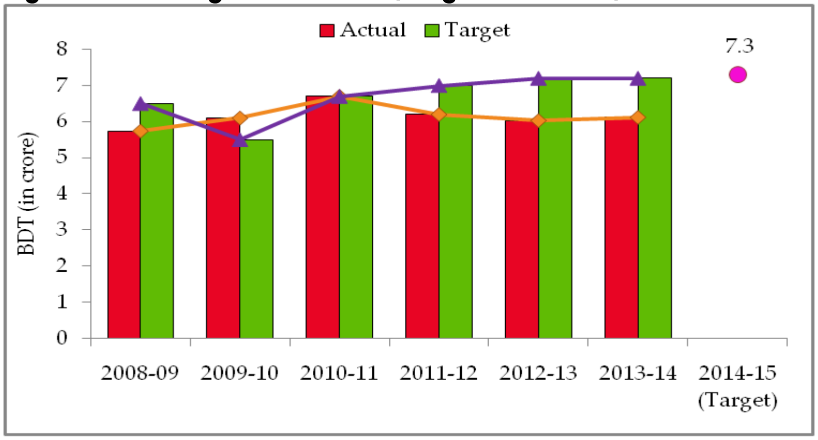
Source: Bangladesh Bank, 2014

BB is consecutively taking contractionary monetary policy which restrained the credit growth in the country, which depresses investment demand and contracts the possibilities of expansion of the economy.

4. GROWTH AND MPS

The country has been facing a low rate of growth which can partly be attributed to its monetary policy. Under the five year MTMF 2014-18, the annual rate of growth in GDP was projected at 8 percent for the FY2014-15. But the projection has been revised and set at 7.3 percent in the current fiscal year 2014-15 instead of 8 percent projected in MTMF. BB is consecutively taking contractionary monetary policy which restrained the credit growth in the country, which depresses investment demand and contracts the possibilities of expansion of the economy. Therefore, it might not be possible to achieve the targeted rate of 7.3 percent growth in GDP in FY 2014-15.

Figure 8: Rate of growth in GDP (Target and Actual)

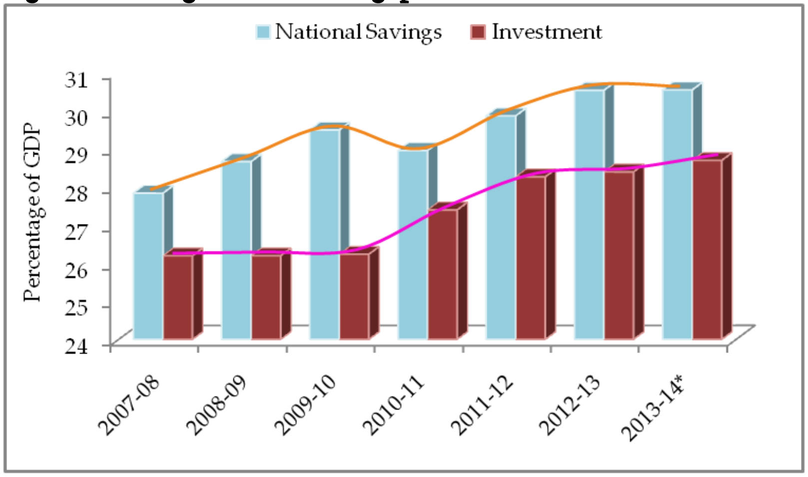


Source: Ministry of Finance, 2014 and Unnayan Onneshan, 2014

Further, the gap between savings and investment has increased over time, which is also a problem for the expansion of the economy.

Further, the gap between savings and investment has increased over time, which is also a problem for the expansion of the economy. An increase in savings and investment ratio increases the rate of growth of the economy. On the other hand, the government fails to create the investment demand due to lack of infrastructure development. The savings-investment gap has been increased sharply and considering the same business scenario it will continue further if the existing policies prevail in future. A gap of 1.6 percent of GDP has been observed between total savings and investment in the FY 2011-12, whereas the gap reached 2.14 percent in FY 2012-13 and slightly decreased to 1.85 percent (provisional) in FY 2013-14.

Figure 9: Savings –Investment gap



Source: Ministry of Finance, 2014

The growth of the economy is often contingent upon adequate supply of credit to the real economy such as agriculture and industry. For example, about 47.30 percent of labour force is involved in agricultural production in Bangladesh. The agricultural production system is mainly small-farmers dominated, with high labour intensity. The small farmers usually cannot accumulate enough capital to invest in production to become more productive. Thus low agricultural productivity is a problem for the economy, which can be tackled through expansion of availability of credit to the farmers. However, despite all tall talks regarding the financial inclusion, all banks in the country do not have an equal distribution of branches in rural areas.

Thus low agricultural productivity is a problem for the economy, which can be tackled through expansion of availability of credit to the farmers.

The industry sector is more in need of credit than the agriculture sector. Unlike the agriculture sector, the industry sector is capital intensive. Moreover, Bangladesh mostly export labour intensive products which the country urgently needs to transform into more capital intensive ones. If the country fails to do so, whether because of contractionary monetary policy, poor investment environment or because of other reasons, the growth of the country would suffer severely.

Finally, despite promoting financial sector liberalisation, interest rate spread (IRS) has n decreased very slightly and lending rate has been remaining high, increasing the cost of capital. Rate of interest on advances is still too high and interest on deposit has been decreasing after July 2013. The IRS in Bangladesh is indicative of interactions of the factors such as high costs of intermediation as a consequence of large non-performing loan (NPLs) and practice of setting higher than competitive deposit interest rates.

The spread of lending and deposit rate, however, decreased to 5.14 percent in April 2014 from 5.15 percent in March 2014. The rate of interest on depositor and lender was 8.11 and 13.25 percent respectively in April 2014 while these were 8.21 percent and 13.36 percent respectively in March 2014. Although the lending rate is on slight decreased lately, the rate is still too high to attract the small and medium investors and enterprises in the economy.

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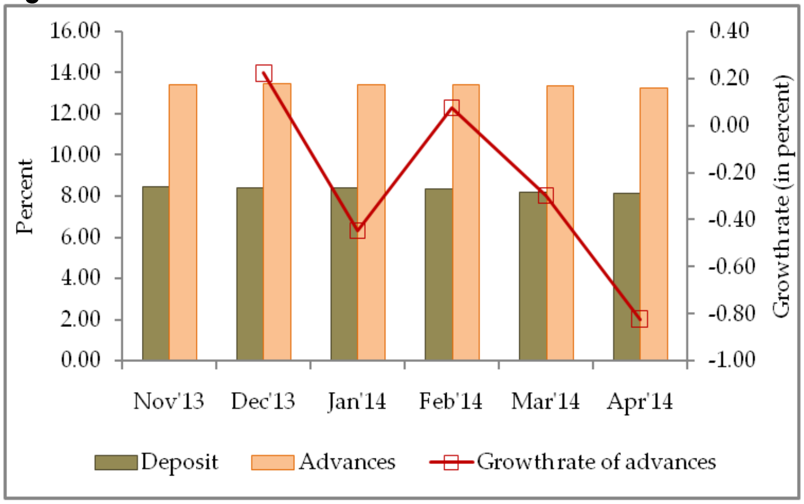
Figure 10: Interest rate



Source: Bangladesh Bank, 2014

5. EXPERIMENTING THE THEORETICAL CREDIBILITY OF MONETARY POLICY FORMULATION IN BANGLADESH

The monetary policy formulation in Bangladesh does not encompass the theoretical underpinnings of neither of the two major theoretical approaches to monetary policy formulation – the "Impossible Trinity" and the "Taylor Rule". The following paragraphs briefly analyse the two theoretical approaches as regards the monetary policy formulation in Bangladesh.

Of late, the global debate on monetary policy making has focused on whether policy formulation should target financial stability in addition to the domestic business cycle in an economy.

Of late, the global debate on monetary policy making has focused on whether policy formulation should target financial stability in addition to the domestic business cycle in an economy. In this regard, there has emanated a question of reconciliation between two widely held macroeconomic policy formulation, namely, Mundell-Fleming "Impossible Trinity" and "Taylor rule" of monetary policy (Sheel, 2014).

In particular, the recent consecutive contractionary monetary policy formulations by Bangladesh Bank which were assumed to address the rising inflationary pressure in the economy factually did not succeed to check the inflationary pressure. Rather, these policy formulations have proved to be merely at the behest of International Monetary Fund (IMF) to satisfy the conditions articulated in the Memorandum of Economic and Financial Policies (MEFP), since the trend of average inflation in 2013 remained upward (6.06 percent in January 2013, 6.78 percent in June 2013, 7.53 percent in December 2013 and 7.48 percent in May 2014). However, prior to considering "Impossible Trinity" and "Taylor Rule" of monetary policy as regards the monetary policy formulations in Bangladesh, a brief sketch of both approaches needs to be presented.

The "Impossible Trinity" states that a country can have only two of the following three at the same time: a fixed exchange rate, free capital flow, and an independent monetary policy (a monetary policy that is free to respond to the domestic business cycle). In a nutshell, according to the "Impossible Trinity", a central bank cannot exercise monetary control and fix the exchange rate simultaneously with an open capital account. However, it has been argued that the best way to resolve the "Impossible Trinity" is to maintain an open capital account, then letting the exchange rate float so as to exercise domestic monetary control through an independent monetary policy formulation. This way of resolving the "Impossible Trinity" is often undertaken in an inflation targeting monetary policy framework.

On the other hand, the "Taylor Rule" implies that how much the central bank should change the nominal interest rate in response to changes in inflation and output. The "Taylor Rule" is a rule-bound monetary policy which requires the adjustment of short-term policy interest rate by the central bank based on a mathematical formula using differentials between a country's potential GDP and actual GDP and between the inflation target and actual inflation. The mathematical formula is as follows –

$$i = r^{*} + \pi^{*} + 1.5\,(\pi - \pi^{*}) + 0.5\,y$$

Where i is the short-term policy interest rate, r^{*} is the long-run or equilibrium real interest rate, π^{*} is central bank's inflation target, π is the actual inflation rate, and y is the current period output gap. According to the "Taylor Rule", the central bank aims at attaining inflation around its target level and output around its potential level. The formula, therefore, stipulates that the positive (negative) deviations of the two variables from their target or potential level will be associated with tightening (loosening) of monetary policy. However, in essence, the "Taylor Rule" postulates that for each one-percent increase in inflation, the nominal interest rate should be raised by more than one percentage point.

According to the "Taylor Rule" equation, the policy interest rate should be 9.13 percent (calculated through taking into account government's GDP projection of 7.3 percent and inflation projection of 7 percent), while it remained nearly 13.35 percent on average during the period of January-April of FY13-14.

Now, in seeking the relevance of both the "Impossible Trinity" and the "Taylor Rule" of monetary policy to the monetary policy formulations in Bangladesh, it has been ironically found that neither of the approaches can be applicable in this regard. As regards the "Impossible Trinity", with an open capital account, Bangladesh Bank still intervenes in foreign exchange market in order to avoid excessive exchange rate volatility and promote export competitiveness while the monetary policy is formulated with a view to satisfying IMF conditions, not making it free to respond according to domestic business cycle. On the other hand, the "Taylor Rule" does also not apply to the formulation of monetary policy in Bangladesh. Since the application of "Taylor Rule" implies that the central bank takes contractionary (expansionary) monetary policy in accordance with positive (negative) deviations of inflation and output from their target and potential levels respectively. The mathematical formula indicates, as regards the formulation of monetary policy in Bangladesh, that Bangladesh Bank should not tighten the monetary policy as it is now. According to the "Taylor Rule" equation, the policy interest rate should be 9.13 percent (calculated through taking into account government's GDP projection of 7.3 percent and inflation projection of 7 percent), while it remained nearly 13.35 percent on average during the period of January-April of FY13-14.

6. SUMMARY AND CONCLUSIONS

Recent decelerating growth of Bangladesh economy has been posing the foremost challenges for the central bank in articulating appropriate monetary policy stances. The decreasing growth in private sector credit does not meet the investment demand; rather the government has been expending the money in different unproductive sectors. As a result, both the private investment and the implementation of ADP remain far away from the target which in turn do not create fiscal multiplier effect in the economy and thus decelerate the rate of growth of the economy.

In addition, increasing trend of inflation, especially food inflation, poses challenges for the central bank. Moreover, higher food inflation compared to non-food inflation has put the marginalsed people into a dire situation.

It seems paradoxical for the central bank of the country to pursue consecutive contractionary monetary policies merely to satisfy the IMF conditions without considering its adverse impact on the economy.

On the other hand, Bangladesh Bank has currently been pursuing contractionary monetary policy which has virtually been failing to address the inflationary pressure in economy. Therefore, it seems paradoxical for the central bank of the country to pursue consecutive contractionary monetary policies merely to satisfy the IMF conditions without considering its adverse impact on the economy.

The current tightening of monetary policy by the Bangladesh Bank seems to be ineffective and therefore requires a new policy approach. Recent declining trend in private sector credit growth, which has factually been causing the growth of Bangladesh economy to decline in the last three years in a row, can be restrained through a harmonisation of fiscal and monetary policy. The central bank may demonstrate its prudence while harmonising monetary and fiscal policy through undertaking an expansionary monetary policy that will ensure private sector credit growth and a fiscal management that will increase government expenditure in productive sectors. Such a harmonisation of monetary and fiscal policy may foster both the investment and employment creation in the economy.

Besides, the current inflationary pressure can be checked by the policy harmonization since increased private investment and employment creation will ensure the use of money in productive sectors and cause both the money and fiscal multiplier effects to work in the economy. As a result, the vicious causality (declined private sector credit growth decreases investment which, in turn, causes growth of the economy to turn down) can be neutralised through channeling adequate resources to productive sectors that will eventually restrain the inflationary pressure and ensure an increasing trend in economic growth in the country.

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